

Submission to the Bills Committee on the Securities (Amendment) Bill 1999

This submission is produced by the Pan Asia Securities Lending Association (PASLA) and provides you with an overview and history of PASLA and also summarises the benefits of securities lending and short (hedge) selling for borrowers, lenders and the market. The paper also addresses some of the misconceptions regarding these products. Finally, it outlines the possible negative consequences for an efficient equity capital market that may result from the introduction of the Securities (Amendment) Bill 1999 as currently drafted.

Overview and History:

The Pan Asia Securities Lending Association (“PASLA”) is an association of firms that are active in the business of borrowing and / or lending securities of Asian and other global markets. At present, there are 36 members, 21 of which are represented by their company’s Hong Kong offices, with the remainder domiciled across six other countries - Malaysia, Singapore, Japan, Australia, the U.K., and the U.S. Importantly, PASLA membership is open to both “international” firms, which are active in global markets, and “local” firms, which are active primarily in their home and regional market.

The primary objective of PASLA is to assist the orderly development of securities borrowing, lending and repo markets in Asia. Securities lending has proven to be a valuable market feature which provides liquidity and hedging capabilities necessary for efficient securities and derivatives markets.

Securities borrowing and lending is a very competitive business. While individual firms involved in the business must have their own unique marketing and business development strategies in Asia to be successful, the members of PASLA, as a collection of major firms in the industry, can provide important benefits to Asian securities regulators, stock exchanges, clearing depositories, and monetary authorities by providing an “industry consensus” on issues that effect the development of the securities lending business. Our feedback from regulators and exchange officials that PASLA has worked with to-date has been very positive. They have appreciated the ability to work with PASLA as an efficient liaison with the industry.

To date PASLA has worked closely with regulators in Japan, Korea, Thailand, Hong Kong, Malaysia, Singapore, Indonesia and the Philippines. We have held round tables in Malaysia, Singapore and the Philippines, which included regulators, revenue, stock exchange representative and the chairpersons of the bankers, brokers and insurance associations.

As recognized in other markets it is very important to have the proper framework in place that will expedite settlement efficiency but also serve as the structure for the continued

development of the domestic capital markets. Securities borrowing and lending are a critical requirement for both. It is very important to have the proper structure that will allow a level playing field for both domestic and international players and allow the necessary amount of transparency. PASLA recommends that the market for securities lending be open to all participants and respective participants negotiate relationships. This includes banks, brokers, life institutions, depositories, pension and mutual funds.

On behalf of the members of PASLA, we have been encouraged by the overall development of securities borrowing and lending and regulated short selling in Hong Kong. The introduction of the Securities (Amendment) Bill 1999 runs counter to the historically positive development of securities lending in Hong Kong. The Association is extremely concerned with the potentially significant negative consequences that the Bill (in its present form) will have on the Hong Kong securities lending market. We hope this submission will provide you with the necessary facts that will assist you and other members of the Legislative Council make well-informed decisions on the Securities (Amendment) Bill.

We have also enclosed a presentation on the basics, industry standards, benefits (and consequences of restrictions) of securities lending with a focus on the Hong Kong securities lending and regulated short selling market.

Thank you very much for your kind attention.

Yours faithfully,

Pan Asia Securities Lending Association

The Pan Asia Securities Lending Association (PASLA) would like to address in brief detail certain key points regarding the benefits to a market and its participants of securities lending and short (hedge) selling. In this paper PASLA will explore the critically important roles of securities lending and short (hedge) selling in the development and maintenance of a successful and efficient equity capital market.

In short, this paper summarizes the benefits of securities lending to lenders, borrowers and the market equally. It addresses some common misconceptions regarding the presence of securities lending and short selling in a market. Finally, it outlines the possible negative consequences for an efficient equity capital market that may result from the introduction of restrictions on securities lending and hedge selling.

Summary of Benefits to Market Participants

Lender: Securities lending is an efficient, flexible and market neutral method of extracting value from assets. Investment Managers are required to focus on putting their assets to maximum use and extracting full value from those assets. They are judged on their performance globally. Securities lending is widely perceived to be the most economical investment choice for extracting full value from managed assets without impacting the price performance or asset allocation of a portfolio. For Lenders, the key benefits are therefore:

- Provides a stable stream of revenues in volatile markets where other sources of revenue may decrease;
- Optimizes returns on long term strategic holdings;
- Offsets custodial and management fees;
- Reduces financing costs by generating cash;
- Helps to outperform benchmarks and other performance evaluation criteria.

Borrower: The primary borrowers of equities are arbitrageurs, alternative investments (“hedge funds”), investment banks, brokers, and retail clients. The main reason they borrow is to hedge (protect) an investment strategy or arbitrage. Other key reasons are to

- Facilitate regulated short sales;
- Augment arbitrage strategies;
- Eliminate failed settlements, thereby avoiding buy-ins;
- Manage risks.

Market: It is well accepted that the fundamental motivation for arbitrage activity is to capture the inefficiencies (price anomalies) in a market. It typically is not motivated by a particular directional view under which the arbitrageur automatically profits from a fall or rise in the share price. Long-term investors generally will benefit from market inefficiencies not being permitted to exist for long periods of time. In addition, securities lending and “hedge” selling enable equity capital markets to introduce new investment products, such as futures and options and encourage their wide spread use by domestic and international investors. Key benefits for the efficient operations of the Market are:

- Permits derivative markets, such as Index and Stock Futures / Options, to trade efficiently and with liquidity and depth
- Improves risk management techniques
- Promotes market transparency
- Increases liquidity creating an increase in commissions and stamp duty
- Enables cash, futures and options market-makers to make markets to provide liquidity
- Decreases volatility as it provides a counter balance therefore preventing large spikes and drops in stock prices.
- Minimizes the costs and incidence of failed trades
- Promotes settlement efficiency
- Reduces transaction costs (narrower bid / offer spreads with increased liquidity)
- Maintains arbitrage-efficient equity markets
- Quickly removes price anomalies from the market allowing prices to reflect the true value of the assets.

Issues Regarding Short (“Hedge”) Selling

- Short selling and stock lending occur as a consequence of market conditions, rather than the cause of market conditions.
- Decisions to sell an asset are driven by a view on the asset value.
- Approximately 90% of hedge selling is for arbitrage purposes, not for unhedged directional short position taking.
- For every seller, there is a buyer. The seller views the asset as being overvalued and the buyer sees the asset as being undervalued.
- The open and close of an index arbitrage related transaction is generally executed in a way to preserve the gap between the futures and the index. Aggressive selling and buying could cause spreads to narrow and reduces profits. Most single stock and index arbitrage are market neutral and therefore should have a limited effect on the market.
- Highly respected pricing models such as Fischer Black Zero Beta CAPM and Sharpe-Lintner Capital Asset Pricing Models have unrestricted short sales as a critical assumption.
- Most convertible bond and warrant investors are looking for yield and not equity performance. These investors sell (hedge) the underlying shares at a premium to the

bond. They are not concerned about performance of the equity as long as they can hedge.

- Unhedged short selling in large volumes to deliberately push a market down is an extremely risky strategy. Since the vast majority of stock loans are executed on an “open” basis and can be recalled at any time, there is a substantial risk of a short squeeze if there is a recall and the trader is forced to repurchase the shares at short notice.
- Pension funds and fund managers are increasingly implementing market neutral strategies due to their low risk. Market neutral strategies require an investor to go long an asset and short an asset of equal value. One asset would be overvalued and the other undervalued.
- Increased education and awareness of short selling strategies permit investors to make educated decisions to protect their investments in volatile markets.

Consequences of Restricting Stock Lending and Short Selling

If a Market is to encourage an inflow of capital, whether debt or equity, it must provide investors with the opportunity to sell when they think an asset or a market is overvalued. Markets also must provide hedging facilities to both domestic and international investors.

Effects of imposing restrictions on Securities lending / Short selling could include:

- Significant capital outflow;
- Reduction in legitimate arbitrage opportunities, thereby greatly reducing market depth and liquidity of the physical, futures and derivatives markets.
- Inability for all Investors to hedge their investment strategies, leaving them unduly exposed to significant losses;
- Inability for long term holders to maximize their returns from securities lending.
- Exodus of both domestic and international investors, which may take years to return, resulting in a profound credit squeeze for domestic borrowers.
- Negative publicity resulting in unfavorable comparisons between Hong Kong and less mature markets.
- Loss of Hong Kong’s status as having the most open and mature markets in Asia.

As a result, Hong Kong may experience a significant loss of international and local investor confidence, impacting both debt and equity markets.

PASLA recommends that it is in the best short and long term interest of Hong Kong that its financial markets continue to have unfettered access to regulated short selling, and stock lending not be restricted in any way. Our goals should be for the long-term success of Hong Kong's financial reputation as the leading financial center in Asia and not the introduction of a bill that may have far reaching negative consequences on Hong Kong's perception as one of the most open and developed markets in the world.

As this paper shows, securities lending is a critical component to the success of any mature market and is an alternative and significant source of revenue for institutional asset holders. To restrict, directly or indirectly, an institution's decision to lend or borrow will seriously and negatively alter the market's structure, resiliency, and overall strength and credibility.

PASLA wholeheartedly supports the Government's commitment to improve regulations and increase transparency in the Hong Kong market. PASLA's charter recommends that we fulfill a role of facilitating cooperation and discussion among domestic regulators and domestic and international lenders and borrowers. PASLA's main goal is to work with market players and regional regulators to implement rules and regulations that create a level playing field for onshore and offshore participation with maximum transparency. PASLA welcomes the opportunity to meet with you, and other interested parties, to arrive at a satisfactory outcome for all market participants.

Yours faithfully,

Pan Asia Securities Lending Association



Securities Lending
Basics, Benefits and Consequences

Pan Asia Securities Lending Association
February 2000

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Section I



FUNDAMENTALS / MARKET PRACTICES

Fundamentals

- Outright transfer - Shares and Collateral
 - Loans are fully collateralized at 102-5% - Cash & Non-cash
 - Daily Mark to Market and collateral Adjustments
 - Lender is made whole by the Borrower for all Corporate Actions
 - Lender foregoes the right to Vote on loans over Record Date
 - Lender can Recall shares and Borrowers can return shares at any time
 - Standard Industry Agreement - Legally Binding - Protects Lenders
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Industry Standards

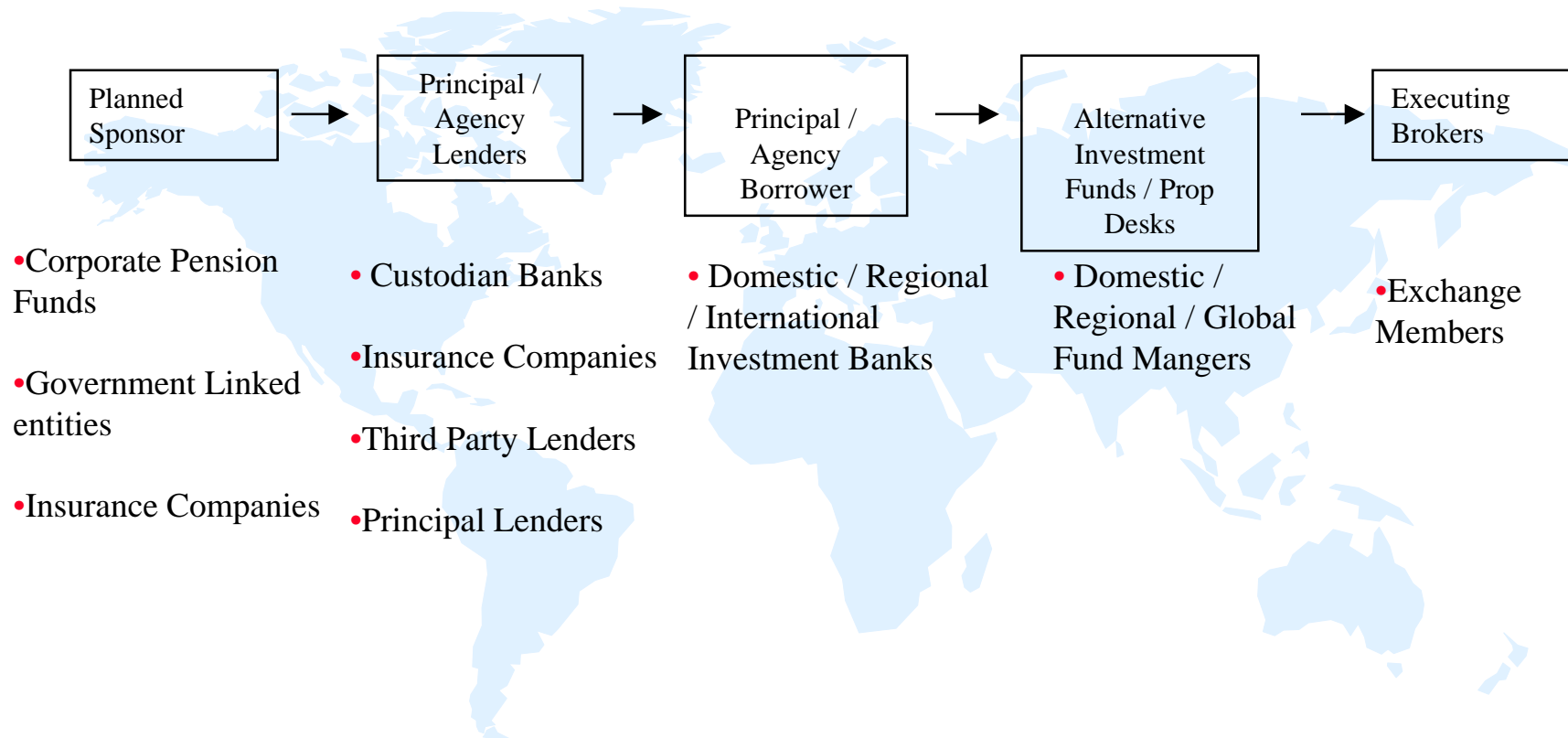
- Lenders do not lend the same stock to multiple borrowers. It is not in theirs or their clients best interest to do this and physically impossible to settle such a multiple loan.
 - Controls, documentation and risk management policies are in place and robust enough to steer through the capital controls in Malaysia, the intervention in Hong Kong and the Japan crisis to Market and collateral Adjustments
 - In no major market is a fund manager, who is in a stock loan program, considered to be short selling if they sell stock that is in a stock loan program nor are they required to provide any documentary assurance or report it other than a long sale.
 - In most markets a verbal confirmation (without a unique identifier) of a “hold” is enough proof to permit the borrower to sell the shares short.
 - In no major market is a breach in the securities lending regulations a criminal offense
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Section II

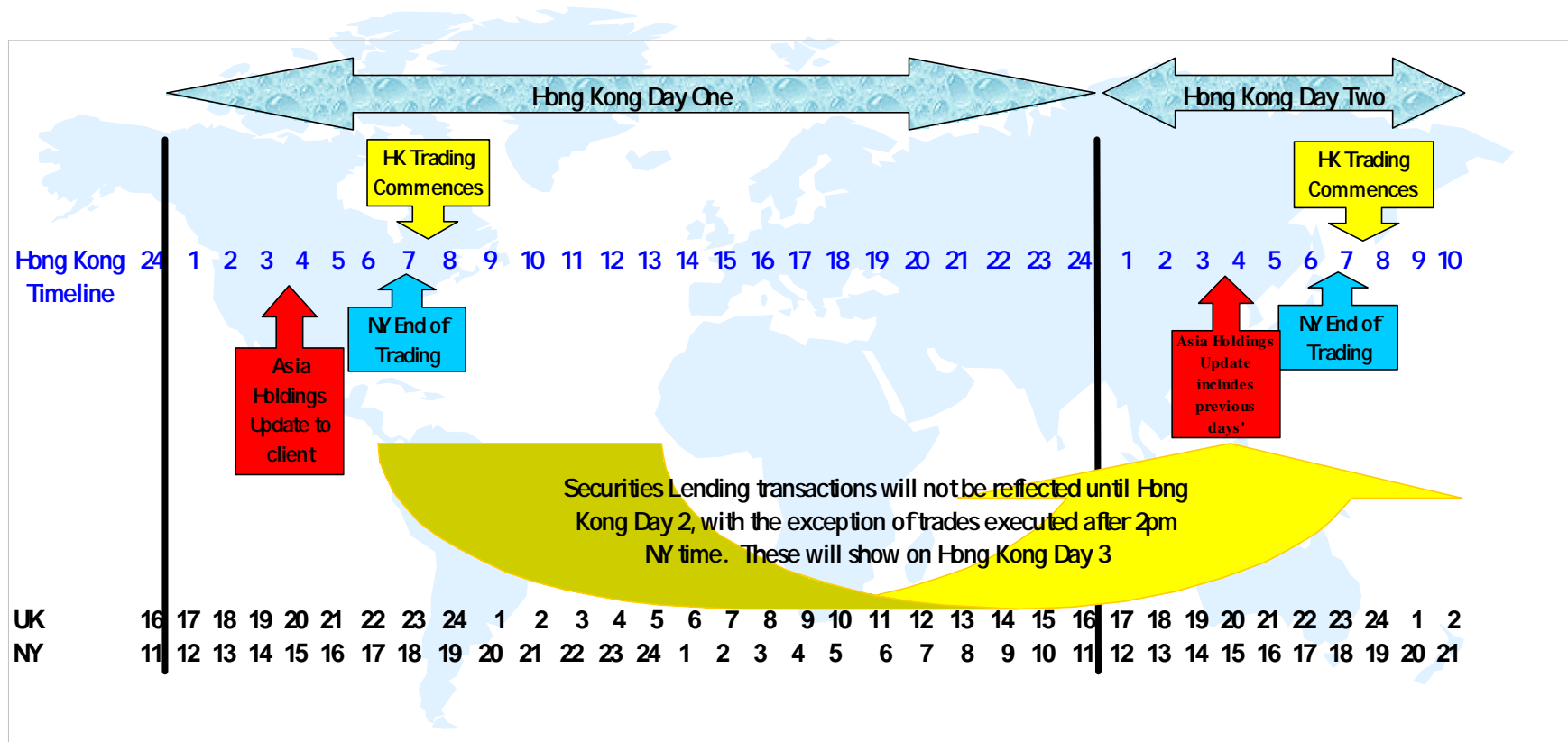


TRADE FLOWS - THE PLAYERS

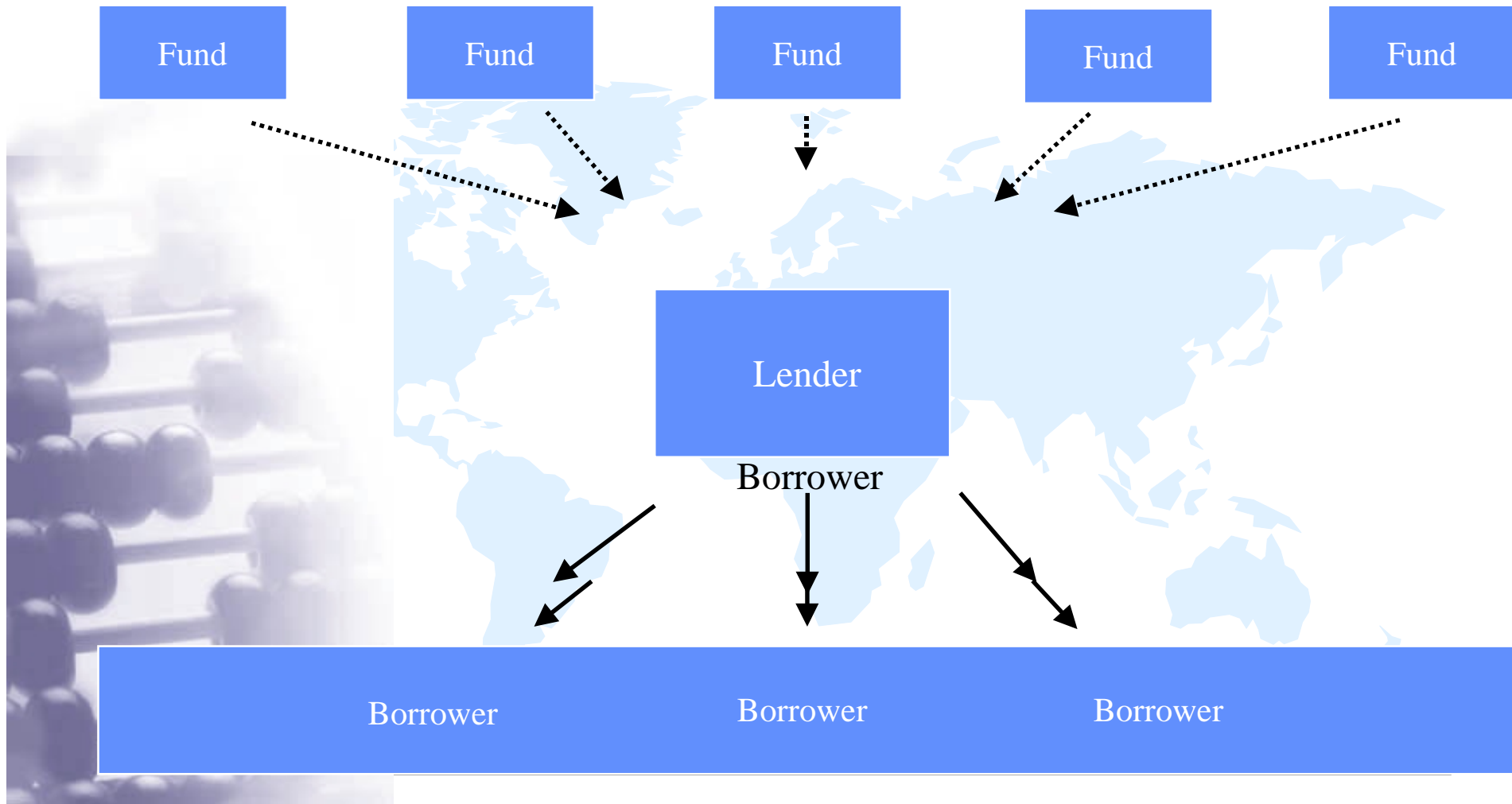
Trade Flows - The Players



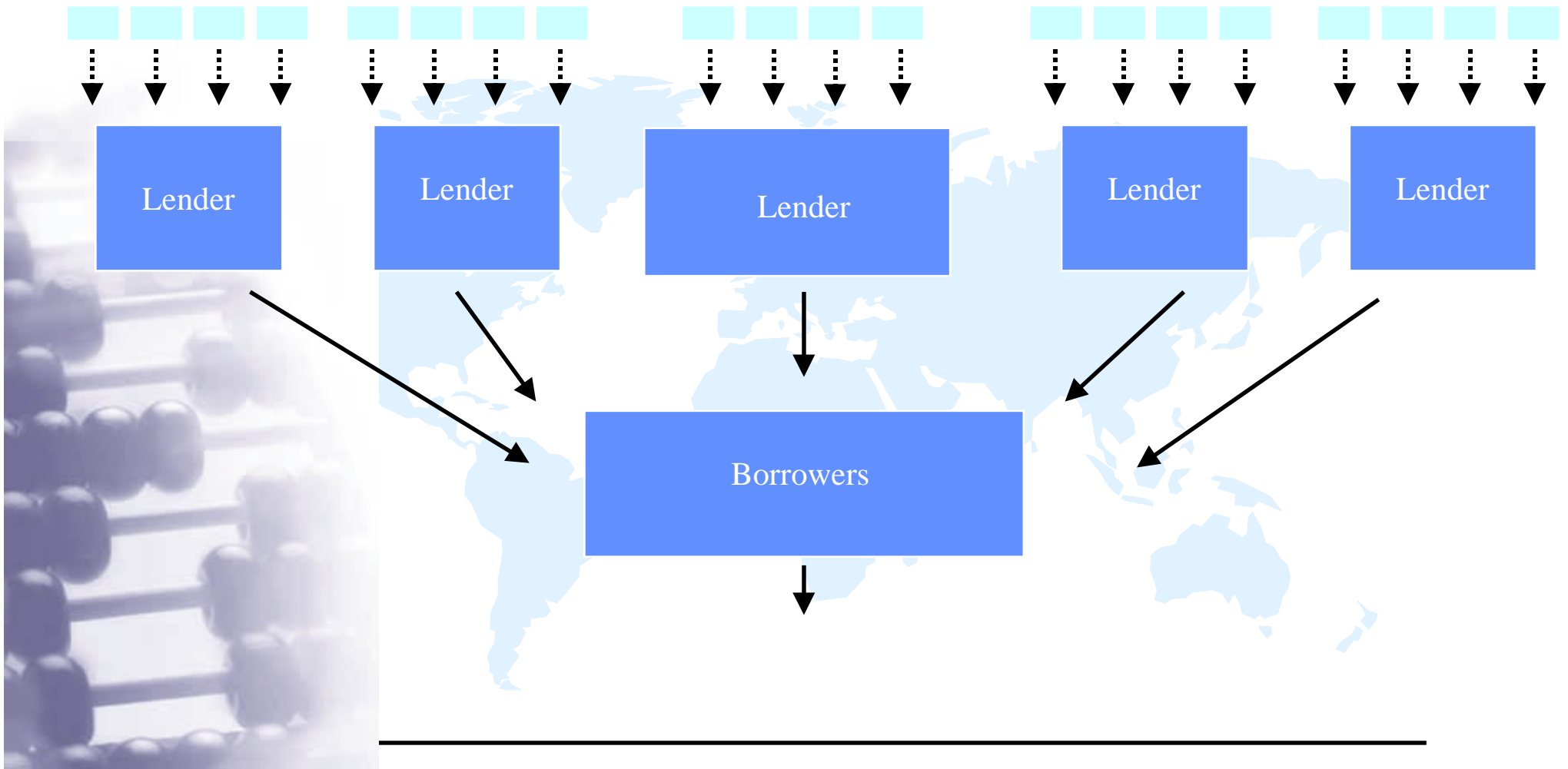
Time Line for a Trade Settlement



Typical Lending Arrangement



Typical Lending Arrangement



Section IV



TODAY'S MARKET- DRIVING FORCES

Today's Market - Driving Forces

- An estimated \$1.5 trillion worth of equities are currently being lent world-wide.
- In excess of 2,000 institutions have entered the Securities Lending Arena.



Demand - Driving Forces

Originally the role of securities lending in efficient capital markets was to minimize the cost of failed trades and enhance liquidity. This remains true however, the market has gravitated towards serving the broad array of trading strategies surrounding the industry that take advantage of market asymmetries in an effort to maintain an arbitrage efficient market.

These strategies include:

- Valuation Discrepancies - Absolute/Relative
 - Convertible Arbitrage
 - Risk Arbitrage
 - Index Arbitrage
 - Pairs Trading
 - Trak Fund
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Today's Market: Driving Forces

Alternative Investments

Prop Trading

Trade Fails

Trading Strategies:

- Convertible Bond Arbitrage
- Index Arbitrage
- Pair Trading
- Valuation Discrepancies
- Fail Coverage (less than 2%)

Market Statistics

- \$5 trillion available to lend
- \$1.5 trillion on loan
- 2,000 lenders

Custodian's

Insurance Co's

Pension Funds

Asset Managers

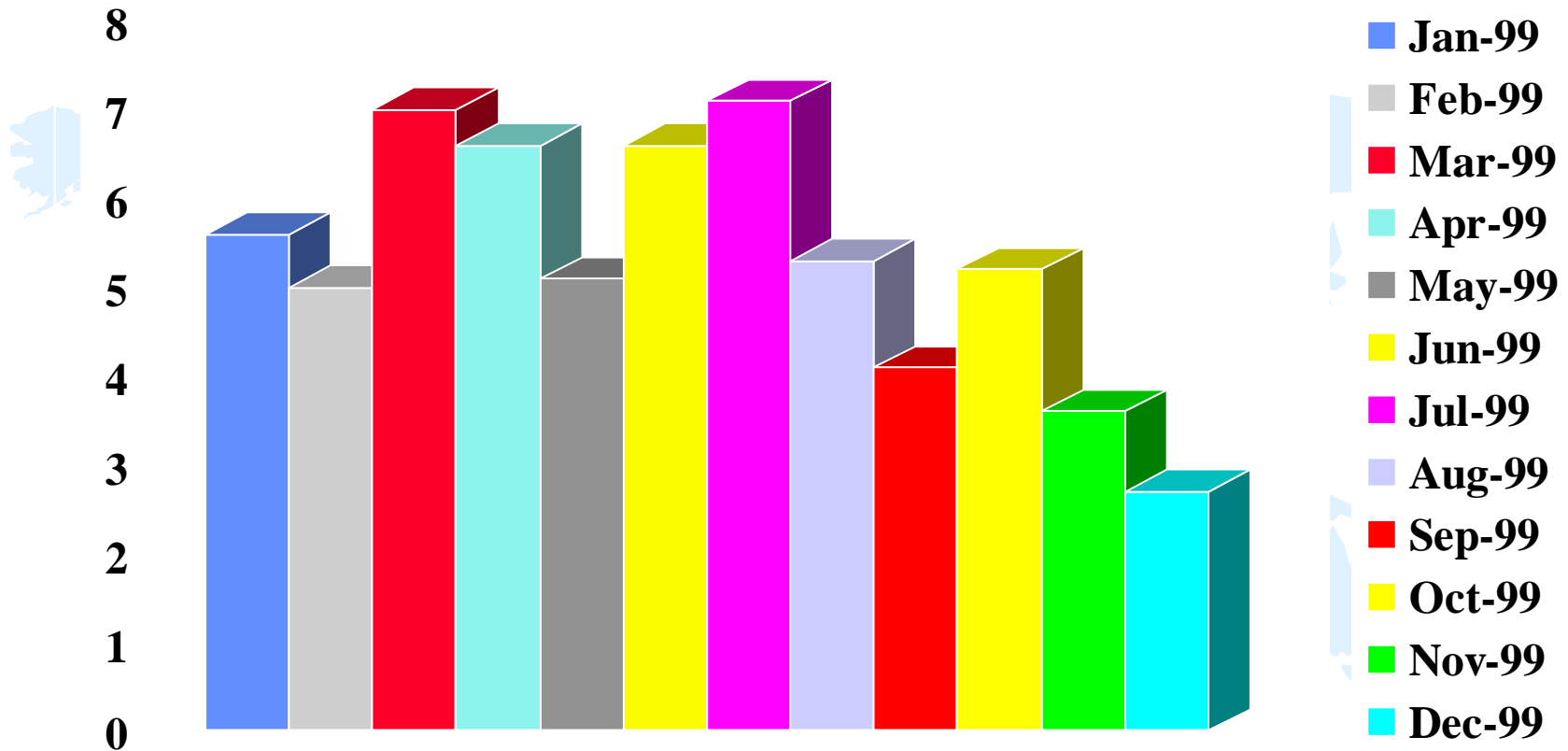
Banks

Section IV



HONG KONG SECURITIES LENDING / ARBITRAGE MARKET

Short Sale Volume for 1999



Market Statistics - Securities Lending

- Overall Availability of HKD Stock for loan is approximately USD 30 billion. Of which 85-90 percent would be impacted by rule change.
 - Outstanding Stock Loan balances are approximately USD 5 - 8 billion.
 - Daily average turnover in Hong Kong is USD 1.2 billion requiring 5-7 days to unwind, not including collateral.
 - Collateral values of USD 10 - 14 billion will have differing investment reinvestments.
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Market Statistics - Equity Arbitrage Trading Strategies

- Short sale volumes for 1999 amount to HKD 63.95 billion on total turnover of HKD 1.9 trillion. This is approximately 3.3 percent of market turnover.
 - Short covering within 1 year would have an equal effect of 3.3 percent.
 - ZZZ short sale exempt strategies of HKD 30,000,000 per day per Options Market Maker.
 - It is important to note that borrows and loans increase settlement volumes apart from ordinary sale and purchase.
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Market Statistics - “Non-Short” Equity Trading Strategies

- The Following trades will often take longer than T+2 to redeem/convert to ordinary shares and require borrows for settlement.
 - ADR long, Ordinary short
 - Convertible Bond long, Ordinary short
 - Warrant long, Ordinary short
 - Option long, Ordinary short
 - TraHK long, Constituent short
- Some conversions will take up to 2-3 weeks to complete. If there is no stock loan available, these legitimate non-short trading strategies can not be executed.

Market Capitalization Statistics

- Market Cap of USD 600 billion.
- Controlled shareholdings of USD 260 billion.
- Free Float of USD 340 billion.
- Lend-able assets of USD 30 billion.



Market Depth of Securities Lending

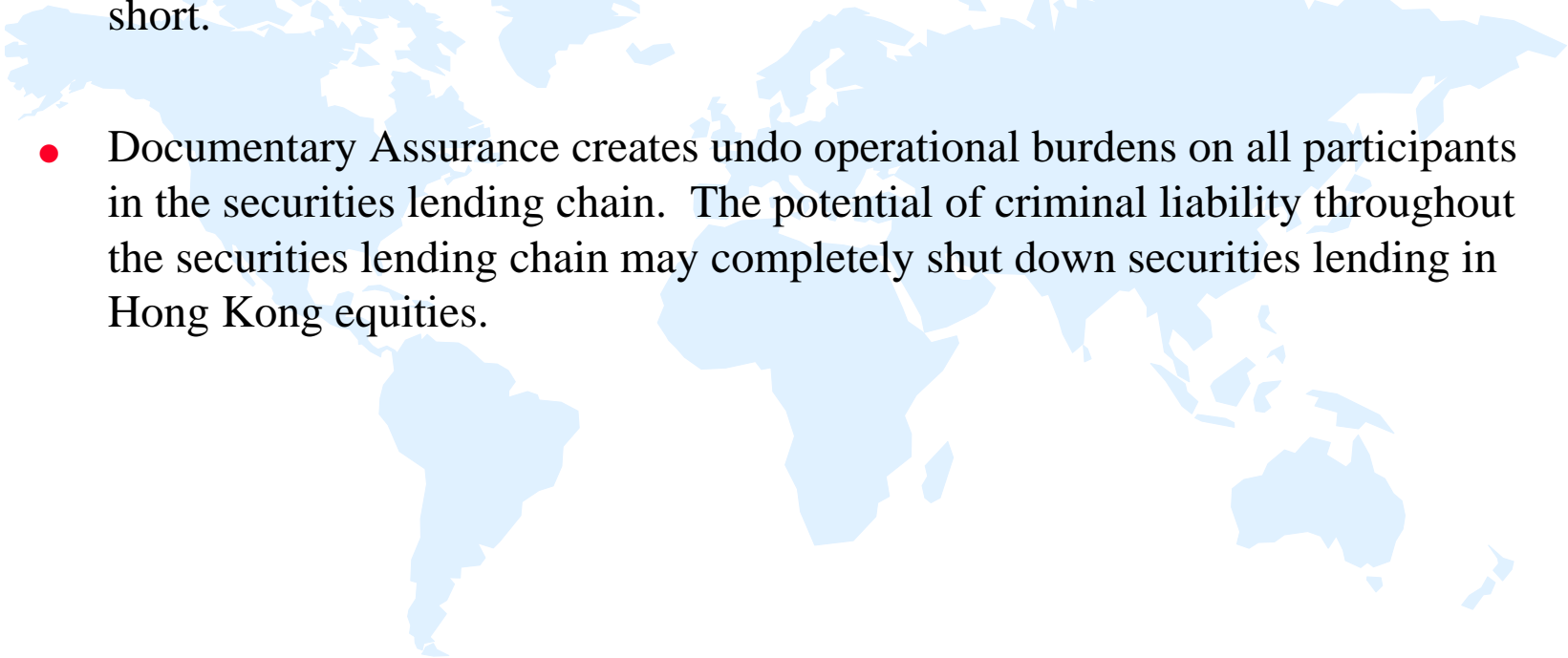
- 21 Hong Kong companies have Securities Lending desks, some of which are the lead product for their Hong Kong office.
 - Hong Kong based, dedicated Securities Lending and Equity Finance professionals total in excess of 50.
 - Prime Brokerage and Support related professionals are not counted in those numbers.
 - Revenues generated by the Securities Lending desks are regional and as such could be moved to other regional centers.
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Section V



CRITICAL ISSUES / CONCERNS

Critical Issues / Concerns

- Scope of Short Selling Order will capture sales by Fund Managers who are in a securities lending program. Most Fund Manager are not permitted to sell short.
 - Documentary Assurance creates undo operational burdens on all participants in the securities lending chain. The potential of criminal liability throughout the securities lending chain may completely shut down securities lending in Hong Kong equities.
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Section VI

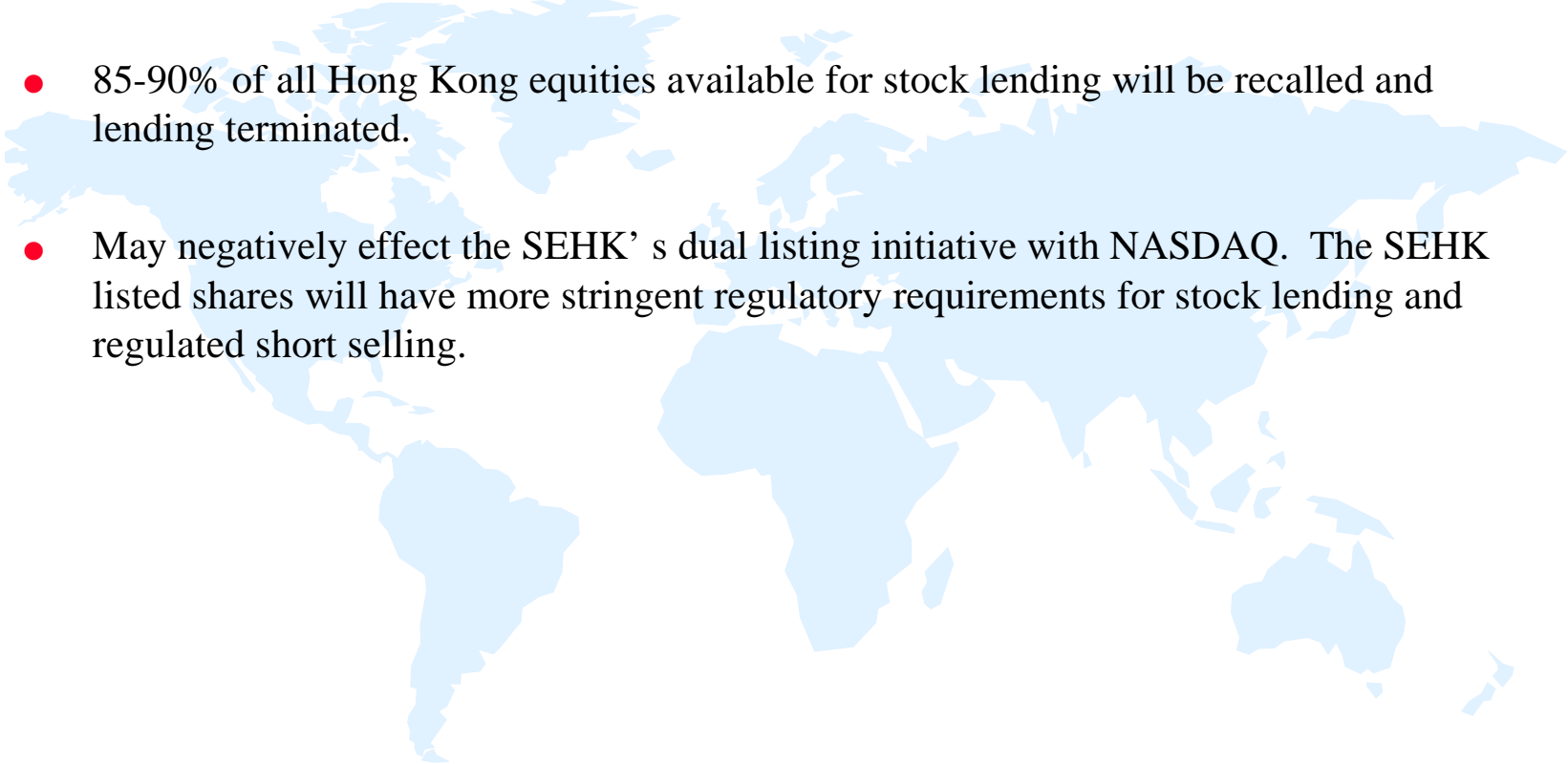


POTENTIAL CONSEQUENCES

Potential Consequences

- Reduction in legitimate arbitrage opportunities, thereby greatly reducing market depth and liquidity.
 - Increased financing costs for Hong Kong and Chinese companies to raise funds via issuance of ADR's, GDR's and convertibles
 - Inability for all investors to hedge their investment strategies, leaving them unduly exposed to significant losses
 - Inability for long term holders to maximize their returns from securities lending
 - Negative publicity resulting from unfavorable comparisons between Hong Kong and less mature markets
 - Loss of Hong Kong's status as having the most open and mature markets in Asia and potential relocation of staff to other regional centers
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Potential Consequences

- Discrepancies between the approved “Bill” and future SFC Subsidiary Legislation
 - 85-90% of all Hong Kong equities available for stock lending will be recalled and lending terminated.
 - May negatively effect the SEHK’ s dual listing initiative with NASDAQ. The SEHK listed shares will have more stringent regulatory requirements for stock lending and regulated short selling.
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Section VII



RECOMMENDATIONS

Recommendations to Protect Fund Managers

- Japanese Solution: Interpretation Relief and Legislative Relief - exempting Investors who are in lending programs from the “short sale” order and are also deemed as selling long if such investor (seller) has a securities lending agreement in place that the securities will be returned without delay upon request
 - US SEC Rule 10a-1(d): Orders can be marked “long” if security to be delivered after the sale if that seller can deliver the security “as soon as possible without undue convenience or expense”
 - If a seller owns the security and it is out on loan a sale may be executed as “long” provided they can recall it and obtain delivery “without undue convenience and expense”
-